



Opportunity seized, opportunity missed

The case for opportunistic real estate
investment in Europe

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J.P.Morgan
Asset Management

Executive summary

- The process of de-leveraging as well as badly needed economic and political reform in Europe will be long, protracted and painful. Turmoil and uncertainty will persist for some time yet but it will also provide the basis of opportunity for experienced investors.
- The real estate market is quickly moving in favour of the opportunistic investor. However, this phase of opportunistic investment will likely be dramatically different from that of previous episodes. No longer will the manager be able to rely almost solely on debt fuelled returns. The backcloth of little or no growth places the emphasis squarely on the ability of the manager to drive investment returns forward.
- Managers with the track record, breadth of financial and operating experience, as well as the credibility with which to mitigate execution risk, are increasingly scarce and will carry a premium in this environment.
- Unlike previous phases of opportunistic investing, no investor will likely be rewarded for taking macro positions on Europe. The winning strategy may have to be underpinned by a recognition of the value derived from the current state of extreme risk aversion, the re-capitalisation of defunct capital structures, the active management of assets which have been in suspended animation for the last 4-5 years and, above all, a recognition that the diversity of the European real estate market is both mispriced and under-valued.

Introduction

The past few years have certainly been a testing time for all investors active in the European real estate market. Sovereigns have been on the brink of collapse, economies show little sign of anything remotely approaching a sustained recovery, and the banking system will remain fragile for some considerable time yet. This period of unprecedented volatility has, at times, challenged the very core of the European experiment. Twenty something crisis meetings have come and gone and each has done little to calm the nerves of fractious investors, much less engender any feeling of confidence.

However what is clear is that, as fear gives way to desperation and panic gives rise to capitulation and despondency, so the real estate market continues to move into the hands of experienced opportunistic investors. The next few years will provide a rich seam for investors with the requisite financial and asset management experience able to navigate through the European storm.

A question of definition

Traditional definitions of opportunistic investment focus on such aspects as development exposure, the level of gearing, the use of trading as opposed to holding strategies or, indeed, the importance of capital appreciation in driving investment returns⁽¹⁾. These are all important attributes of opportunistic investment. However, although such definitions are helpful, they do not reflect, in any way whatsoever, the sort of investment environment unfolding across the European real estate market. At the very core of opportunistic investing is the use and management of risk to generate outsized returns. Opportunistic investors strive to take advantage of dislocations in the capital market, mispricing, illiquidity and the opaqueness of local markets by bringing together a source of capital, operating expertise and an entrepreneurial approach to the management of risk.

The case for opportunistic investment

The case for opportunistic investment has been well made in a series of recent research reports⁽²⁾. The evidence needs to be treated with caution as the absence of a long and robust history of performance makes for tentative conclusions at best. Nevertheless, that evidence which exists in both the USA as well as Europe points to a number of important observations:

Total returns – Opportunistic real estate funds have generated total returns well in excess of core or value add vehicles over the past 15 years in both the US and Europe.

Alpha – The evidence points to a strong source of alpha in the opportunistic space which can be crystallised when acquiring assets at distressed prices.

Risk adjusted returns – On a risk adjusted basis, opportunistic funds appear to have outperformed both core and value add vehicles across different economic scenarios over the last 15 years.

Vintage – Opportunistic funds launched during a period of severe downturn, or recession, tend to perform better than those vehicles launched later in the cycle which suggests a first-mover advantage. This may reflect the fact that funds launched later in the cycle have to target a broader array of markets, will end up with a higher proportion of unrealised investments and, of course, may need to increase the use of leverage.

Past, present and future

It is important to recognise that the attributes and pattern of historic performance described above were the result of specific market conditions in terms of debt availability and growth which are simply not going to prevail in the immediate future (Exhibit 1). The opportunistic market of tomorrow will be dramatically different from anything that has gone on before. This does not detract from the strength of the case to invest opportunistically; it simply places the onus on the investment manager to deliver performance in a radically different economic and market environment.

Exhibit 1 | It's opportunistic investing, but not as you know it!

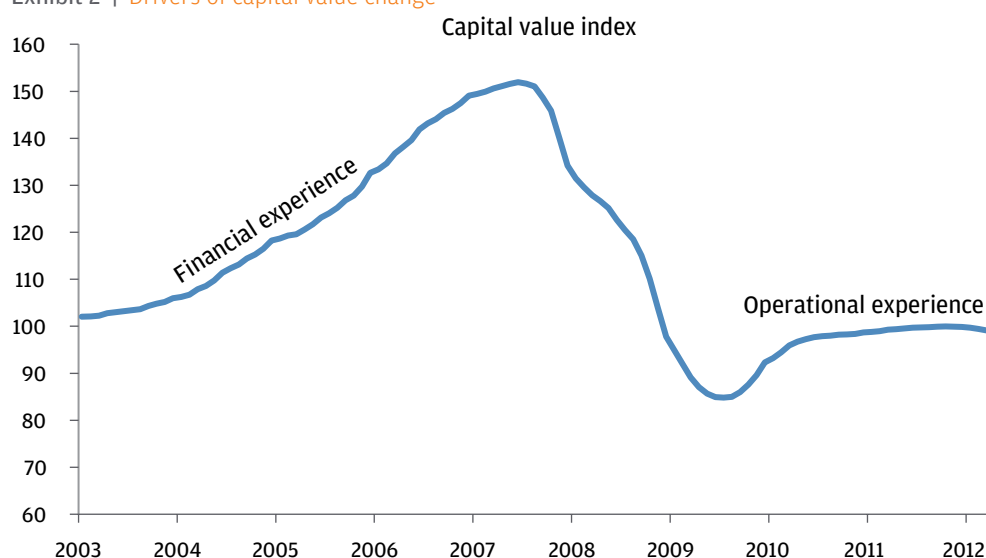
Key themes	Early 2000s	Today	Implications for the investment manager (IM)
Macro positions	The European market was both opaque and inefficient. It was also the subject of frantic de-regulation and increasing EU accession. This allowed for significant re-pricing of markets allowing macro positions to be taken (CEE or German residential).	Improvements in transparency and liquidity transformed the market in terms of pricing efficiency. At the same time the increased polarisation in performance precludes the taking of macro positions on particular sectors or specific regions.	The IM has to have direct access to local markets and network of partners.
Financing	Opportunistic returns in the early 2000s were both reliant and fuelled greatly by the availability and cost of debt. Investment strategies could be very simple – acquire property, ensure it was highly geared and wait for yields to compress.	The pool of commercial real estate (CRE) debt is and will be much reduced. Managers will also need to contend with substantially lower loan to values (LTVs) and higher margins.	The IM with a good track record and good relationships with the major lenders will be able to take advantage of stapled debt in the opportunistic segment of the market.
Growth	At the time Europe was enjoying a period of unprecedented growth, in the midst of a long bull-run where property investment came to be seen as risk free.	Economic recovery will be slow and painful with little or no growth in the medium term. This means that one of the most important drivers of opportunistic returns will be less significant.	The IM has to rely increasingly on hands-on, operational expertise.
Investment returns	Investment returns were driven primarily by debt and relatively high rates of economic growth.	Investment returns will be more modest and, as important, the key driver of value growth has shifted most decisively to the ability of the management team.	IM with the financial and operating experience will have a distinct competitive advantage in counteracting the effects of lower growth and less debt.
Definition of core	Development activity was at a high point providing a steady supply of core assets to the institutional market. At the same time demand for such assets was restricted primarily to domestic institutional sources.	Extreme risk aversion has led to a redefinition of core. Core assets have to have a “tick in all the right boxes” meaning that even those assets with minor impairments, and otherwise regarded as institutional in a more normal market are being priced as secondary.	IM will be able to take advantage of assets with minor impairments and otherwise regarded as institutional through injection of capital and active management
Investment universe	During the early 2000s, investors had to go to Tier II and III markets and the smaller and less liquid central and eastern European (CEE) markets to generate the sort of opportunistic returns required.	The opportunistic investor is being rewarded for taking risk even in the larger and most transparent markets in Europe. Extreme risk aversion has meant that reasonable returns can be generated in major centres throughout Europe.	Local knowledge and experience in core markets will be crucial for the IM
Execution risk	The weight of capital and, in particular, the ready availability of debt, greatly reduced the level of execution risk in the market.	The process of de-leveraging and general risk aversion has increased overall risk of successful execution of transactions.	The credibility of the IM will be critical in convincing counter parties of the ability to successfully complete complex transactions
Investment management industry	Characterised by a wave of new managers with little or no track record or experience of depressed markets.	The investment management industry has consolidated as evidenced by the number of funds looking to raise capital. Regulatory change (Alternative Investment Fund Managers Directive) will speed up this process.	IM with deep financial and operating experience of depressed markets are at premium
Leasing markets	Real estate cycle was characterised by a synchronised recovery and growth phase across the European market which, over a period, spilled over to Tier II markets as well as the periphery.	The downturn was not synchronised whilst performance has subsequently been highly polarised. This divergence is evident in both the leasing and capital markets.	The bifurcation of markets provides opportunity for the IM at both ends of the spectrum. To take leasing risk in those markets which continue to experience low vacancy and development activity and seek changes of use in markets with structural levels of vacancy.
Development activity	Development activity in the early 2000s was at peak levels with the highest construction boom in most of the major European markets.	Development activity has been low in most locations throughout Europe during this cycle. This has led to a shortage of grade A stock for occupiers as well as an increasing shortage of investment stock for institutions.	The IM with refurbishment and development experience will be able to feed the institutional appetite for core investment assets which the market has failed to deliver.

Source: J.P. Asset Management

Different drivers of investment returns

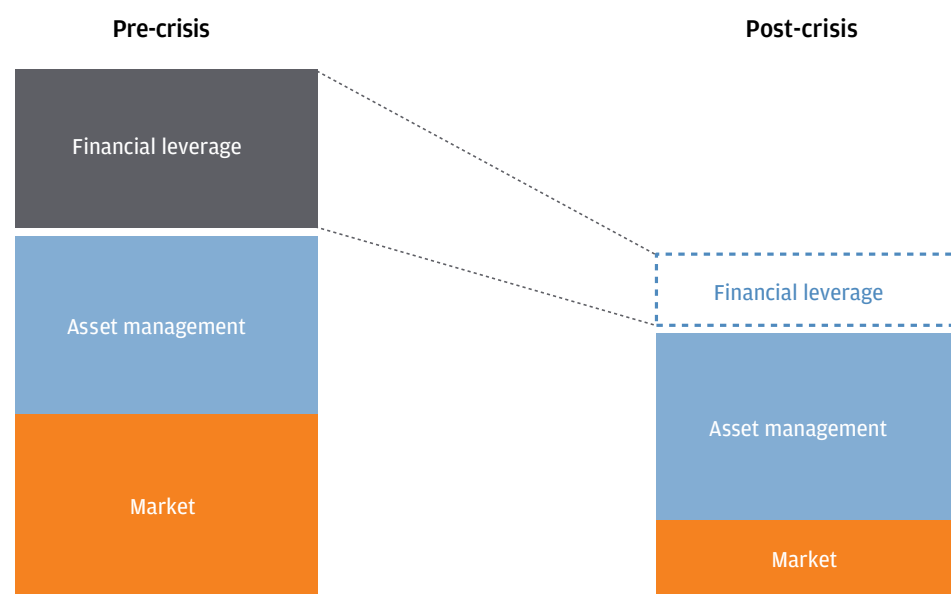
As the market continues to move sideways, with little evidence of a robust or sustainable recovery in values, the driver of value growth has shifted from debt to the asset manager's ability to create value. The increasing shortage of debt in commercial real estate (CRE) and the prospect of little to no macro growth in the short term will inevitably lead to more modest returns at the opportunistic end of the market. However, of equal importance is the fact that the real driver of value creation has shifted to the asset management team, their track record, operational experience and credibility in mitigating execution risk.

Exhibit 2 | Drivers of capital value change



Source: J.P. Morgan Asset Management, IPD

Exhibit 3 | Contributors to investment returns

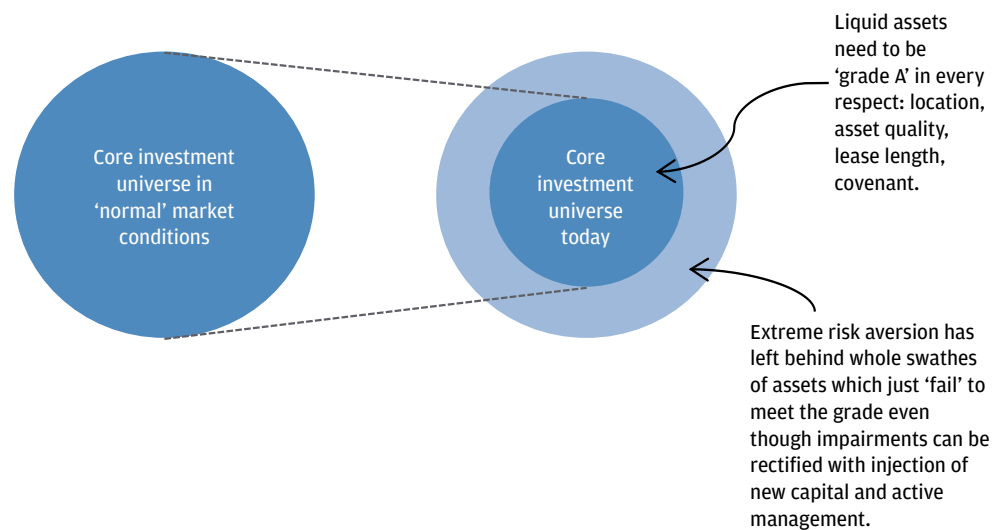


Source: J.P. Morgan Asset Management

Capital really does have value

Not only has the majority of investment capital gravitated to the core market, but in so doing, has re-defined the very meaning of core. Extreme risk aversion has meant that the investment universe of 'core' property has shrunk during this cycle. As a result, a large proportion of assets previously considered institutional but with minor impairments or, slight blemishes, are now being priced as secondary.

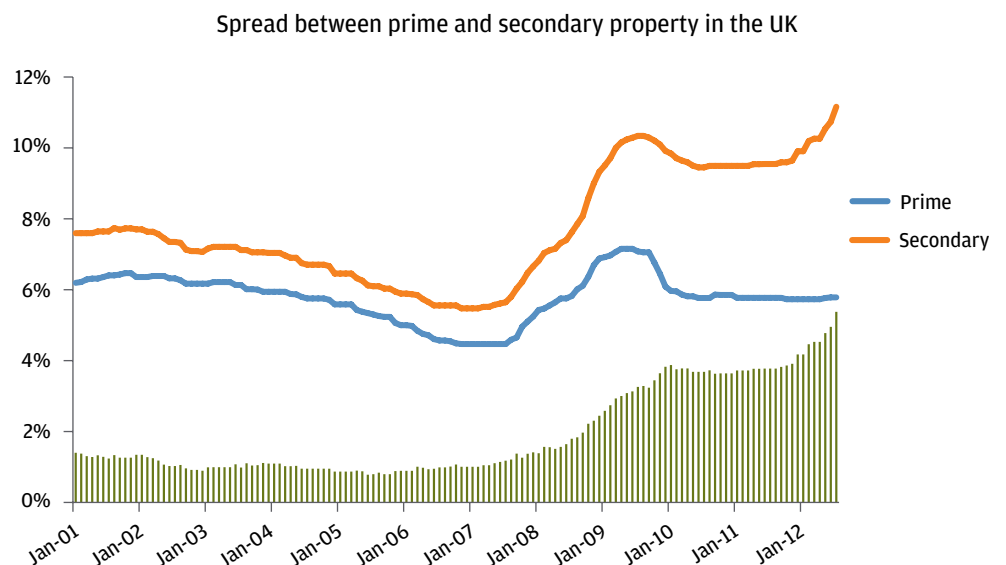
Exhibit 4 | Risk aversion shrinks definition of core today



Source: J.P. Morgan Asset Management

Moreover, these institutional assets in good locations are being mispriced as secondary despite having defects which are easily sorted through an injection of capital, or simply by improving its management.

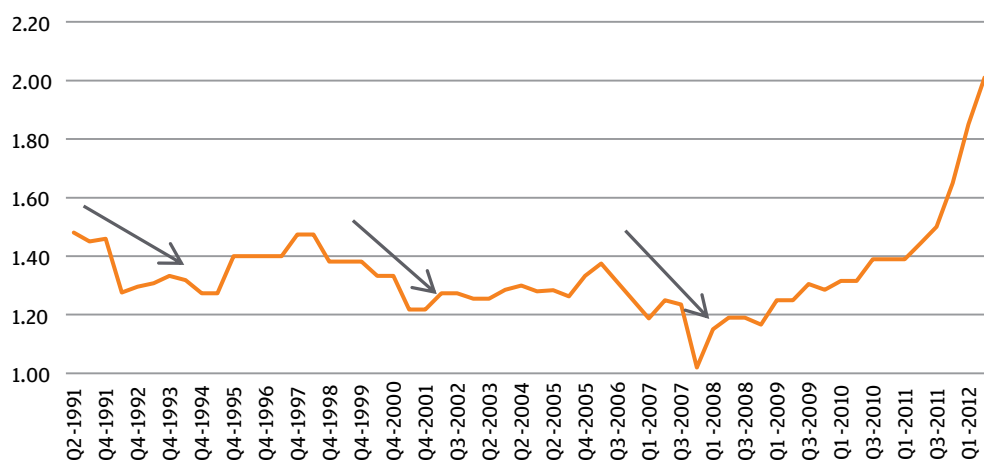
Exhibit 5 | Secondary pricing at attractive spreads



Source: J.P. Morgan Asset Management, CBRE

Furthermore, what is abundantly clear is that yield spreads between prime and secondary markets are now at a point previously unseen. Going as far back as the early 1990s, yield spreads narrowed in the early 1990s, the early 2000s and again in 2006-07. They are correctly at their widest margin reflecting, above all, the extreme risk aversion evident over the last couple of years. It may be unreasonable to expect these spreads to narrow to the 1% gap seen in 2007-08, but a narrowing to 1.2%-1.3% would appear reasonable from their current level of 2%+."

Exhibit 6 | Yield spreads - Prime v Secondary Markets (bps)

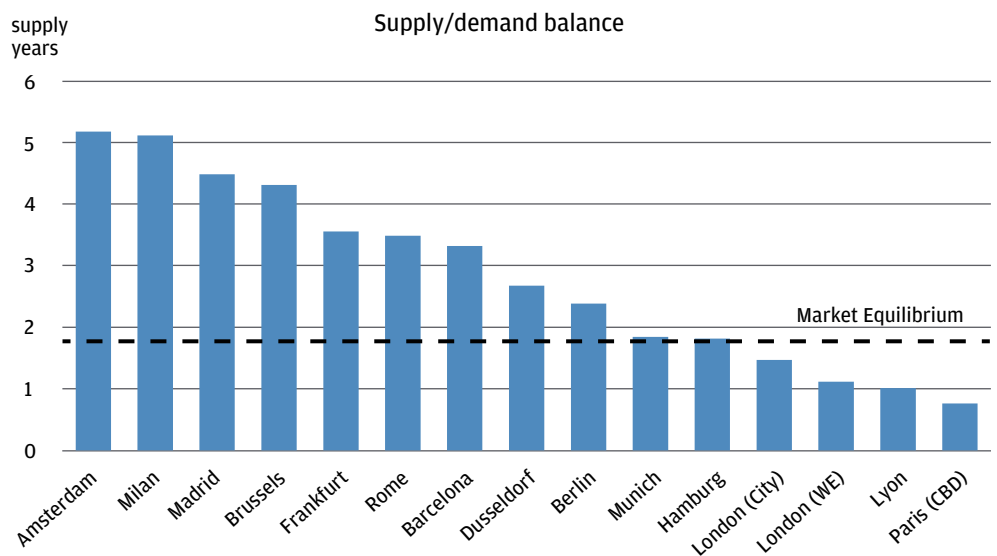


Source: DTZ Research, as of June 2012

Diversity is mispriced and under valued

Given the scale of the economic and political problems around Europe, it is inevitable that the region is being treated as a single, coherent entity, and priced accordingly. However, the decline in values was not synchronised and neither has been the long and gradual recovery. The performance of both leasing and investment markets has continued to diverge in terms of performance and that is likely to exacerbate in the future. The polarisation of markets creates ideal conditions for opportunistic investors to thrive in: taking on leasing, refurbishment and development risk in markets with strong leasing fundamentals and a positive outlook, as well as creating value through re-zoning and changes of use in markets where vacancy has reached structural levels and a large proportion of vacant office space is not likely to return to productive use.

Exhibit 7 | **Polarised Markets**

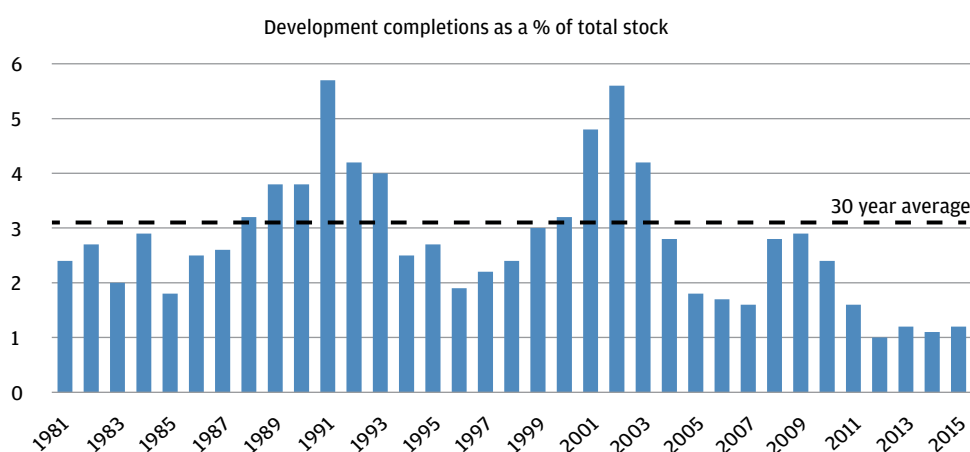


Source: DTZ Research, as of June 2012

Development cycle

Real estate development activity around Europe is at a 30 year low. This means that, despite the economic downturn, there is not only continuing demand for quality space from occupiers, but also a relatively low supply of new quality assets for investors as well. The lack of quality stock available in the investment market has been made all the more severe by the strong inflow of long term institutional and sovereign wealth fund capital from outside the region.⁽³⁾

Exhibit 8 | Development is at a 30-year low



Source: PMA, as of June 2012

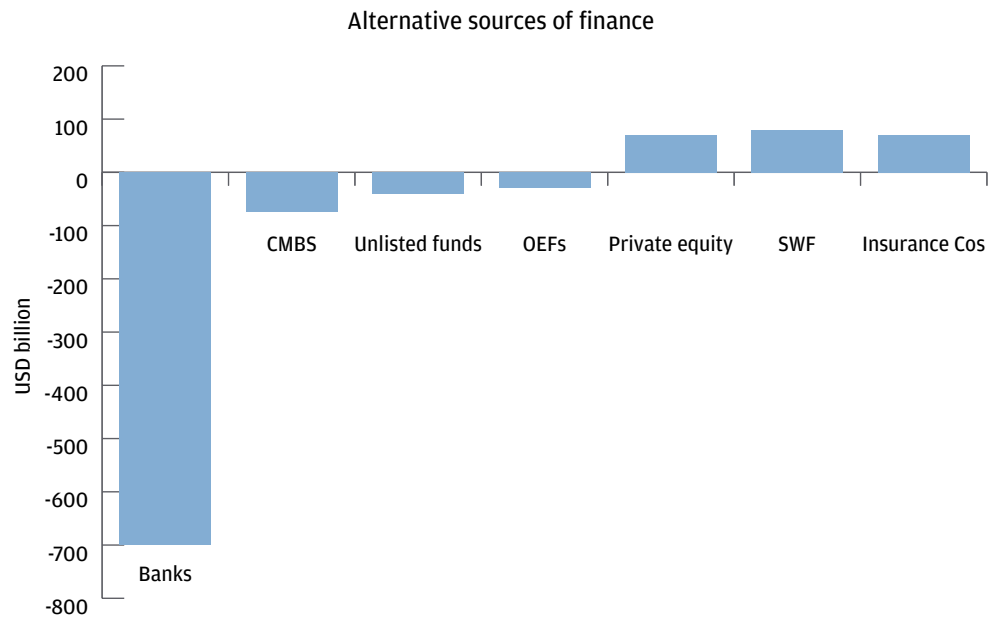
Where's the product?

Much of the attention has inevitably focussed on the banking sector as a source of investment grade product and, in particular, the fact that we have not yet seen the promised wave of distressed assets on the market. The banking sector in Europe has announced sales of EUR 200bn over the past 24 months although only a relatively small proportion of this has actually been executed. Even so, the level of announced sales account for less than one-third of the toxic balance sheet in the sector as a whole. Banks will become a major source of investment product but, for the time being, it is reasonable to assume they will seek to maintain the slow trickle of assets into the market.

While banks are between a rock and a hard place, successive rounds of liquidity injected over the past three-to-four years have been successful in providing something of a respite. The transfer of assets from bank balance sheets into the market has been slow and ponderous, and though there is now evidence that this is picking up, the indications are that banks will seek to hold those assets that continue to pay a coupon in the hope that time will solve the valuation issue. There is however another group of assets which have been in 'suspended animation' for the last three-to-five years, where borrowers have lost all equity and where the banks have been unwilling to inject the required capital to maintain values. These are the assets in the process of being placed on the market as the banks have come to recognise that the failure to invest over the last few years is costing them dearly as the deterioration in value is unlikely to recover any time soon.

As pressure continues on the banking sector, so the funding gap is wide and getting wider over time. Indeed, the funding gap in Europe has now doubled over the past 12 months to an estimated USD 200bn as the new wave of banking regulation begins to take hold. The funding gap is unlikely to be plugged in its entirety by alternative sources of finance such as life companies and the sovereign wealth funds.⁽⁶⁾ This gap will inevitably lead to further pressure on pricing for those assets currently held on bank balance sheets.

Exhibit 9 | Alternative sources of finance



Source: Morgan Stanley, as of March 2012

However, distress comes in many different guises and banks are certainly not the only source of distressed investment stock. Many German open-ended funds are now in liquidation mode and will need to dispose of EUR 25bn plus in core European markets over the next couple of years – a scale of disposals which will undoubtedly impact on pricing in specific markets.

As a group, real estate investment trusts (REITs) appear to be least distressed but they will also be net sellers in the short to medium term. The pressure on REITs comes from trying to reduce leverage, fuel existing development plans in the absence of sufficient debt in the market, and the need to focus on core competencies. Raising new capital in this environment is both difficult and dilutive with equity markets remaining volatile and the majority of companies trading at a significant discount to net asset value (NAV).

The unlisted fund sector will also be major sellers as many of the unlisted funds are coming to the end of their lives as well as seeking to exit as a result of increased cost overheads following the recent introduction of new European Union (EU) legislation.

Finally, central and regional governments will definitely make up a large component of distressed real estate sellers particularly in peripheral European markets. All governments are seeking to raise new capital and the historic portfolios held by the public sector is a potentially important source of value. A number of significant portfolios have recently been placed on the market and this trend is one that is likely to continue over the next one-to-two years.

Case study

Distress comes in many different guises

Continuous waves of liquidity from governments and central banks have enabled European banks to delay the transfer of distressed assets onto the market. This process will inevitably speed up but for now will remain slow and torturous. However, the banking sector is by no means the only source of investment grade product for the appetite of opportunistic investors.

Take, for example, the sell-off of EUR 25bn plus of real estate assets held by the German open-ended funds in the process of liquidation.

This will give rise to two important trends. First, a significant increase in investment product from distressed owners but second, and more importantly, the concentration of these portfolios will inevitably lead to an increase in pressure on pricing in specific sectors and local markets. Over 80% of the European portfolio of the German funds is in the office sector. Given that over half of all the office stock held by these funds is to be liquidated, the impact on pricing will be significant – especially since office transactions have made up less than one-third of all investment volumes traded in Europe over the last five years.

Most of these office properties are held in Germany and France and, in these markets, we do not expect there to be a significant impact on pricing as the major markets in both countries are liquid and likely to remain so in the foreseeable future. However, the funds also hold substantial portfolios in the central and eastern Europe (CEE) and Benelux where market conditions are dramatically different. Take the Netherlands for example, where pricing is already under pressure, as vacancy levels continue to rise. In Amsterdam there is now 1.1 million sqm of vacant space; an approximate 20% vacancy level. One-quarter of these vacant office buildings is owned by the same German funds and roughly 30% of the vacant buildings are financed by German bank loans.

The net result is inevitably a substantial fall in office values in a major European market and significant opportunities in terms of ‘changes of use’ including the re-zoning of office space that will never come back into productive use.

Case study

There is no shortage of owners in denial

We recently saw the latest announcement of some of the progress made by governments in recognising the hole they are in as well as an indication of how far we still are from finally drawing a line in the sand.

By way of background, the first half of 2012 saw a dramatic fall in investment activity in Spain with just five commercial sales closed in Madrid and Barcelona. This is not surprising given that liquidity vanished in these markets as the economy deteriorated in Spain and investors focussed their activity on the larger, more transparent investment markets in core Europe. The regional government in Madrid announced a disposal programme of a portfolio in the city which, as it turns out, is a good example of what we are likely to see in the coming months, as well as a great example of the fact that many distressed owners have not yet fully grasped the extent of the pain to come. The regional government will embark on a disposal programme of about 100 assets with the first round comprising the sale of 15 properties of around EUR 62m. This process highlights a number of issues:

- First, the relatively small lot sizes of the initial disposal programme. This could be attractive to local investors in Madrid, particularly high net worth individuals, but is unlikely to attract much interest from international capital.
- Second, because the disposal programme comes from a public sector body, it will need to adhere to a strict bidding process which can be long and cumbersome with considerable risk that it may not actually be executed in the end. This too is likely to act as a deterrent to international investors.
- The third element is price. The Government is looking at a discount of 15-20% on current values. Such a level of discount is going to be wholly inadequate and, more than anything else, reflects the state of denial which continues to afflict many of the distressed owners in the region.

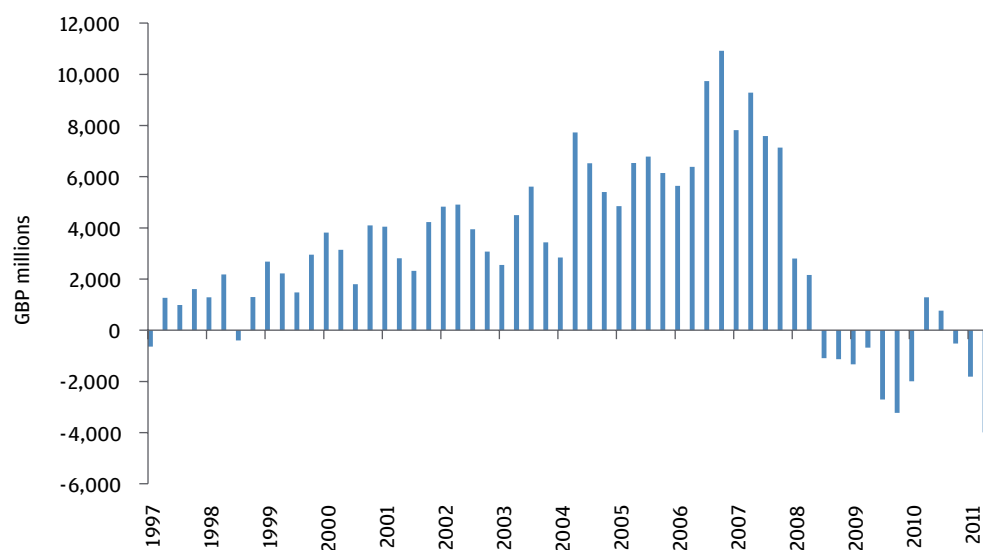
Similar portfolios have recently been marketed throughout Spain, Italy and Portugal. Few have transacted but only in cases where far greater discounts have been secured. Pricing for these types of assets will weaken further and this market will continue to move in favour of the opportunistic investor.

Debt financing

The pressure on the banks to shed real estate loans and assets will be a major issue for some considerable time. The availability of bank finance in real estate will continue to dwindle⁽⁴⁾. Banks will come under increasing pressure to lend to the corporate sector and consumers, whilst lending to real estate will continue to be seen as not just unprofitable but marginal, given the totality of the problem across the European economy. Real estate lending will continue to be scarce and rationed to the two ends of the spectrum. Core investors will continue to access debt albeit at lower loan to values (LTVs) and higher margins but so will opportunistic investors who will be able to take advantage of stapled debt at the higher end of the risk spectrum⁽⁵⁾. In both cases, only good-quality sponsors will be able to access debt as banks not only consider the quality of the investments but also the quality of the borrowers.

The stapling of debt is inevitable if banks are to succeed in cleaning up their balance sheets of those assets that have been in suspended animation over the last four-to-five years.

Exhibit 10 | Changes of UK banks' net lending to property companies

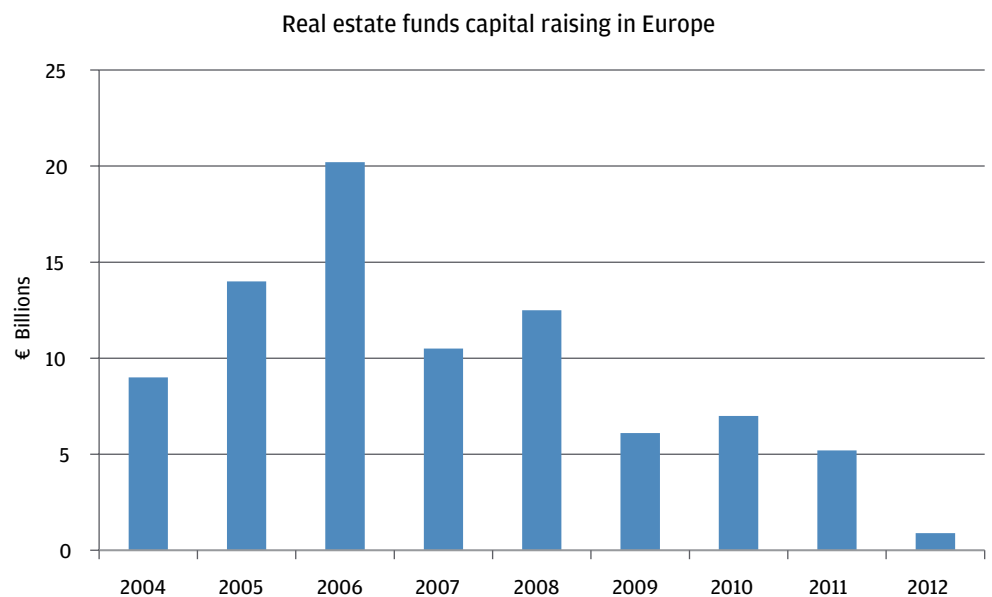


Source: Bank of England, as of June 2012

Scarcity value

During the course of this real estate cycle, there has been a dramatic fall-off in new funds seeking to raise capital in Europe. There are all sorts of reasons for this including the general level of risk aversion, the troubled history of unlisted funds and consolidation in the industry, as well the effect of new EU regulation which is beginning to take its toll on the size and nature of the investment management industry. One unintended consequence of this is the comparative scarcity of credible and experienced managers with the mix of financial and operating experience required to create value in this environment. Credible asset managers are rare, carry a premium, and will have a considerable competitive advantage in the years ahead.

Exhibit 11 | **Manager Experience is Scarce**



Source: PERE, as of June 2012

Regulatory change also important

The nature of the opportunity unfolding across Europe comes not just from the shock to the capital markets and the distortion to the leasing market but from the nature and pace of regulatory change as well. The effect of Basel III and Solvency II have been well chronicled and serve to quicken the pace of change amongst banks as well as other institutional investors. But regulatory change is also beginning to have unexpected consequences as in the case, for example, of the German government's position on the Alternative Investment Fund Managers Directive (AIFMD). Implementation of the directive has prompted the Government to introduce a clause into domestic legislation which, to all intents and purposes, discourages institutional investment in new open-ended funds. The consequence of this will be increased redemptions as investors take heed of the new legislation, and hasten the demise of such vehicles from the European investment market.

The opportunistic market continues to move towards the investor...

The low appetite for risk amongst investors, the range and diversity of equity active in the market, and the shrinking pool of debt financing available has meant that pricing has and will continue to move in different directions depending on where the investor sits on the risk spectrum. The lion's share of capital flows have targeted the core market and then only in the largest and most liquid markets around Europe. This segment of the market remains highly liquid and pricing remains competitive. Indeed, there are no bargains at this end of the real estate market. Such a situation is in sharp contrast to the opportunistic market where there is not only a surplus of supply over demand but prices will continue to soften.

Risk	Capital/stock balance	Key themes/rationale	Liquidity	Pricing
Trophy assets	Excess demand over supply	Strong global equity flows Long term horizon Wealth retention Reliable income Liquidity	Very liquid	Fair value
Core	Excess demand over supply	Increasing supply (Banks and OEFs) Mix of domestic and global capital Debt is available Rental growth Stable income	Liquid	Fair value
Mid-risk	Excess demand over supply	Increasing supply Leasing uncertainty Little debt available Mispricing of risk	Illiquid	Mispriced
Opportunistic	Excess supply over demand	Increasing stock from banks/OEFs Little debt available Distressed sellers Capital market shift Significant discounts to book value Regulatory change	Liquid at a price	Mispriced

Source: J.P. Morgan Asset Management

An opportunistic investment strategy for Europe

Given the level of continued uncertainty in the market, the shrinking pool of CRE debt and the prospect of little or no growth on the horizon, an opportunistic strategy for the European region has to be founded on four key elements:

1 – Extreme risk aversion

The market conditions that have characterised this market cycle have led not only to a level of extreme risk aversion with a complete focus on core, but more importantly to a redefinition of core itself. Unless the asset meets narrow criteria in terms of location, asset quality, length of lease or covenant, it will tend to fall outside the institutional market for which there is ample liquidity. The market has over-reacted and the net result is a large swathe of good quality and institutional real estate that has been temporarily left high and dry. It may be that such assets have a little vacancy, or the lease length may be on the cusp of what is deemed acceptable – minor impairments that can be rectified through an injection of fresh capital or the active management of the asset itself. These assets are now being priced as secondary, but will re-price as the market takes stock.

2 – Recapitalisation

The balance sheets of European banks may be stuffed full of distressed assets, yet only a trickle has come to the market. Frequent injections of liquidity have provided something of a safety net for banks that simply have not been forced to sell in the current conditions. It has allowed banks to hold onto those assets that continue to cover interest payments and where, basically, the bank is more than happy to simply collect the coupon.

However, there is another, much larger group of assets on bank balance sheets which are languishing and whose values are deteriorating by the day. These properties need capital and management but have been in suspended animation for a considerable time. The borrower having lost most, if not all of his capital and the lender with inadequate asset management skills and an unwillingness or inability to invest are faced with a pool of assets whose value is deteriorating at ever increasing speeds. These are problematic assets whose impairments can be ameliorated through the deployment of fresh capital and/or hands-on active management.

3 – Divergence is mispriced and under-valued

The European market is priced as if it was a single entity. But nothing could be further from the truth. Not only did the downturn lack any real synchronicity but the pattern of performance and the outlook for recovery continues to show a considerable degree of divergence. The degree of polarisation will increase allowing opportunistic investors to seek value at both ends of a polarised market.

4 – Asset management

Most important of all, the sort of opportunistic investment market unfolding in Europe is unlike anything in the past. The key driver of returns has shifted from the ability to deploy debt to the quality of the investment manager. Their credibility, track record and hands-on operating experience will be the key differentiating factors in this new investment cycle.

Opportunity I - Extreme risk aversion	
Definition of core	Risk aversion has led not just to a flight to core but a re-definition of low-risk assets. The investment universe for core assets has shrunk resulting in a universe of institutional assets in major markets that are currently being priced as secondary. A group of assets which have minor impairments capable of being rectified by an injection of capital and/or active management.
Attractive pricing	The opportunity to acquire good quality assets at historically attractive pricing and, in a segment of the market, which will continue to be characterised by limited competition.
Yield spreads	Yield spreads between prime and secondary, tier I and tier II markets as well as between core and peripheral Europe are at an all time high. These will correct and markets will re-price as Europe stabilises over the medium term.

Opportunity II – Recapitalisation	
Capital structures	Fixing capital structures through fresh injections of capital. There is an increased recognition by existing owners and the banks of the need to exit, or partner, at realistic prices.
Capital starvation	Quality real estate managers in both the public and unlisted markets are in increasing need of fresh capital. This will become particularly evident as bank activity shrinks back into their respective domestic markets. The result will be a significant starvation of capital, particularly in regions such as the CEE and Benelux.
Suspended animation	Whilst banks have been holding on to real estate on their balance sheet, they have neither actively managed nor supplied the sort of capital required to sustain value. There is, therefore, an opportunity to acquire assets which have been in suspended animation for the past four-to-five years and starved of capital and operating expertise.
Structured finance	Provision of financing above that of the senior lender. Structured investments with the opportunity to participate in future capital appreciation.
Special situations	Entity level restructuring and public to private activity. Raising new capital is both difficult and dilutive with equity markets remaining volatile and the majority of real estate companies trading at a significant discount to NAV.

Opportunity III – Divergence is mispriced and under-valued	
Economic polarisation	Whilst regional growth will be modest and rather anaemic, the outlook at a city level will continue to be polarised. Some of the largest and most dynamic centres have remained resilient to the downturn and show a positive outlook in terms of rates of growth and net positive absorption going forward.
Tight leasing markets	Over the medium term, there is likely to be strong demand for development and refurbishment activity able to deliver the type of modern space capable of meeting occupier needs. The European market will be characterised by a shortfall in quality stock over the next two-to-three years.
Structural vacancy	Whilst vacancy remains low in the major markets, there are a number of other important markets which are subject to structurally high levels of vacancy. This will provide the opportunity for “changes of use” particularly in cities with a strong demographic base and high quality of life index.
No macro risk	Increasing polarisation and little or no growth will preclude investors from taking macro positions in this phase of the opportunistic investment cycle. The strategy has to be highly focussed and selective rather than taking a macro position on a particular region or sector.

Opportunity IV – Value creation by asset management	
Hands-on experience	The asset manager will be the main driver of investment returns in this cycle. The manager has to have the operating and financial expertise required to drive returns against a background of substantially less debt and rates of economic growth.
Sourcing of transactions	The ability to source transactions and leverage local relationships to achieve competitive advantage will be critical in determining a successful opportunistic investment strategy.
Credible manager	The track record and credibility in the market of the investment manager is crucial not just in being able to access debt but in reducing the level of execution risk associated with complex transactions.
Scarce resources	This mix of operating and financial experience required to drive returns is increasingly scarce following the turmoil of the last few years, and the impact of regulatory change which will speed up the pace of consolidation in the investment management industry. Those constraints on capital and operating experience provide an attractive environment for pro-active managers.

Source: J.P. Morgan Asset Management

Footnotes

- (1) Typical definition of investment styles according to the European Association for Investors in Non-Listed Real Estate Vehicles (INREV).

Investment style			
	Core	Mid risk	Opportunistic
Total return expectations	6-8%	8-11%	15%+
LTV	<40%	40-60%	>60%
Timing	Highly sensitive to market cycle	Sensitive to market cycle	Less sensitive to market cycle
Market access	Competitive bid		Mainly off-market
Risk	Minimal leasing risk, lease expiries and capex requirement	Modest leasing and vacancy risk. May include light refurbishment	May include refurbishment and ground-up development risk
Holding period	Long term hold (10 years+)	5-7 years	Short term (2-3 years) with active trading strategy
Driver of value	Income growth	Balance between income and capital	Mainly driven by capital appreciation
Income driver	>60%	50%	<50%
Non income producing as a % of the gross asset value (GAV)	<15%	15-40%	>40%

Source: INREV as of February 2012

- (2) See for example:
- RREEF Real Estate Research, The Case for European Opportunistic Investing, 2011
 - Shilling J. & Wurtzeback C, Is Opportunistic Investing Beneficial? If so, Why?
 - NCREIF-Townsend, Real estate Fund Index, 2012
- (3) PMA, 2012
- (4) See for example
- DTZ, Money into Property, 2011
 - CBRE, European Capital Markets, 2012
 - Real Capital Analytics, 2012
- (5) PMA, 2012
- (6) Morgan Stanley, Banks Deleveraging and Real Estate, 2012
- (7) De Montford University, Bank Lenders Survey, 2011

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